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CREATIVE ACCOUNTING AND CASH FLOWS REPORTING

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Abstract. *Financial reporting system has been developed to provide reliable information for its users. However, regardless of how much is striving that financial reporting system provides quality information, yet there are certain circumstances that can lead to misleading financial statements. The occurrence of irregularities is affected by the following factors: complex economic reality, the accounting policies and estimates, participants in the process of financial statements preparation and presentation, specific processes within the recognition and measurement of specific positions in financial statements etc.*
Creative accounting is performed transformation of the financial statements of what is really and what the subject want to show using the existing rules and/or ignoring some of them. It can affect the amount of reported profit, the amount of reported net assets and the amount of reported net cash flows from operating activities. In this paper, the term creative accounting will be used for labeling of accounting acts made in order to present the desired and not the real picture of cash flows from operating activities.

Key Words: *financial reporting, creative accounting, cash flows, operating activities.*

INTRODUCTION

In the last few decades there are many scandals about fraud and collapse of big companies such as Enron, WorldCom, HealthSouth and many other less known, which were, according to their financial statements, operating very successfully. As more of these scandals is revealed the distrust in the financial statements and financial reporting and accounting in general is growing more and more. All this leads us to the question: Is it possible to rely on the financial statements and to make right business decisions based on them?; Whether they are and to what degree the information in financial statements are correct?; Do the companies do as they show their business in their reports? This calls into

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question one of the basic objectives of financial reporting – providing the necessary information for stakeholders.

Also, the question remains what is and what is not allowed in financial reporting. Whether accountants use their resourcefulness too much in preparing financial reports and with such actions overused choices that are allowed by the accounting regulations and whether the information contained in that reports are characterized by intelligibility, relevance, reliability and comparability as the primary characteristics of accounting information.

Each act in the financial accounting that was undertaken in order to create a different image from the real can be classified as creative accounting. There are not clearly defined boundaries of approved and disapproved and not clearly defined when some act in creative accounting made by the accountant exceeds the flexibility of accounting regulations and turns into a criminal act. Creative accounting is applicable to all financial statements. However, the subject of this paper will be a Cash flow statement as the subject of creative accounting.

What has recently evident is the growing importance of indicators based on cash flow compared to the other traditional indicators. The cash has become a central issue for the managers and the main indicator of business performance. That's why in literature we often meet with sayings such as: cash is a king, cash is the fuel that runs the company, cash is the bloodstream of the company…which shows the importance of this resource for the company in the modern business environment. Today, in business world, the company with less degree of profitability and higher degree of liquidity is more respected then the company with reverse performance.

All this, led to the fact that accountants pay more attention to the cash flow reporting and in this field attempt to show the company's operations better than they are. Steps in the reporting of cash flow and creative accounting at all, are possible to be taken in terms of accounting standards, by using their flexibility or beyond them. However, regardless of whether it is permissible or impermissible acts of creative accounting, a common characteristic is to blur the true picture of the business and thus may lead decision makers and other users of financial statements misleading.

In this paper we will highlight the importance of cash flows reporting, define creative accounting as a phenomenon and explain some of possible manipulation with cash flows as a result of creativity in the process of financial reporting.

1. CASH FLOWS FINANCIAL REPORTING

Cash is one of the key elements of the assets of each company, and cash flows are considered as a bloodstream of the company. Lately, the analysts give the advantage to the cash flow analysis rather than profit analysis. Cash flow calculation includes cash items that are excluded from the profit (capital investment, working capital, new loans, repayments of loans from past period…), while profit on the other hand involves more revenues and expenses from the period, independently of cash inflows or outflows.

According to many authors, the cash flow is superior performance measure than profit because of several reasons (Djuričin, Lončar, 2010):

1. Cash flow more accurately shows the performance than profit („cash flow is a fact, profit is an opinion“).
2. Cash flow shows a lower degree of volatility in comparison to the profits that is liable to jumps and falls.

3. Cash flow partiality to the liquidity is more appreciated than profit partiality to profitability.
4. Cash flow is more comprehensive measure that reflects a company performance, since, under the same other conditions, includes the investment and financing.

Accordingly, Statement of Cash Flows is a more appropriate measure of business performance than the Income Statement. The Income Statement includes the effects of activities on accrual basis expressing them as the difference between revenues and expenses allocated to the relevant accounting period. Because of more or less income and inflows mismatching and expenditures and outflows for a specific period, usually the result (profit/loss) reported in the Income Statement (the relation: incomes – expenditures) does not match the result determined on a cash basis reported in the Statement of Cash Flows (the relation: inflows – outflows). Because of that, in practice are often situations that companies despite the high net profit reported in the Income statement have decreasing of cash balance and problems with current liquidity maintaining.

All this indicates that for successful cash flow management it is necessary to “adjust” the result determined on an accrual basis (the Income Statement) so that approximates the net cash inflows from sales activities (Stančić, 2006).

In accordance with IAS 7 – Statement of Cash Flows, cash inflows and outflows during the accounting period are exercised by: operating, financing and investing activities. These three groups of activities include a variety of sources and uses of cash, and are shown in the Statement of Cash Flows.

Cash flows from operating activities are result of primary activities of the company and that are the income-generating activities resulting from the regular business activities of the company. Operating cash flows are related to the following activities: sale of goods, services on the market, payments to suppliers for materials, goods and services, payments of various costs (production and non-production services, payment of salaries and other operating expenses), payments for other liabilities (taxes and contributions...)…

Because the operating activities include all activities from the main activity of the company, the sustainability of total cash flows directly depends of the sustainability of cash flows from operating activities.

Realized cash flows from operating activities indicate (Djukić, 2005):

- A level of company’s success in generating net cash flows from operating activities.
- Trends in net cash flows from operating activities during the period.
- Main reasons for the positive or negative net cash flows from operating activities.

The investing activities are related to the evaluation and selection of investments whose lifetime is longer than one operating year, or investments whose effects are expected in the long period of time. Cash flows from investing activities are related to following activities: purchase of property, plant and equipment, sale of intangible assets, investments in long-term financial instruments (stocks, bonds), as well as the sale of securities in the financial market.

Transactions from financing activities are those that a company receives from shareholders and creditors. These activities as a result have the change of the size and structure of companies funding – the relationship between own and borrowed capital.

Cash inflows and outflows arising from these three activities are presented in the Statement of Cash Flows as one of the basic financial statements. Statement of Cash Flows explains how the amount of cash as an item in the Balance Sheet at the beginning of the period became another cash amount shown in the Balance Sheet at the end of the reporting period, and what is, in the reporting period, contributed to that (Libby, Libby, Daniel, 2011). Accordingly, the Statement of Cash Flows provides users with the following information (Pavlović, Bogdanović, 2013):

- Where from does the cash come during the reporting period.
- How cash is used during the reporting period and
- What are the changes in cash on the end compared to the beginning of the period.

Cash flows reporting is regulated by the International Accounting Standards (IAS), and especially IAS 7 – Statement of Cash Flows. Within these there are rules defined for preparation and presentation of this report, but however there is left a space to accountants to maneuver within the prescribed rules and thus affect the final image of the company's business.

2. Definition of Creative Accounting

In the modern business environment which is primarily characterized by turbulence, dynamism and every day survival risk increasing for even most successful companies in the market, management is under constant pressure to achieve defined strategic corporate objectives and therefore make a good impression in the eyes of the owner. In order to protect themselves and to make a good impression as managers, even in the situations when it is not possible to make a good result, managers can dare to certain illegitimate actions. More precisely, if management do not achieve the good financial performance of the business that do not meet the expectations of the owners, they can use some accounting procedures in order to improve final appearance of financial reports and amounts in financial statements and to present them different from the real situation. According to this, we can make a distinction between pure and creative accounting.

The term „pure accounting" means accounting in real financial reporting and preparation and presentation of financial statements in accordance with the prescribed Framework for Financial Reporting, i.e. Reports that do not contain significant material errors and irregularities, which objectively and fairly reflect the asset and profitable position of the company. It is the accounting that is legal and legitimate. By contrast, „creative accounting" means the intentional taking of measures aimed at the preparation of financial statements that don't show the right material and yield strength of the company. It can be said that there has always existed certain adroitness (creativity) of accountants in preparing financial statements, but that it had never had this big size and that the consequences were not so much visible as it is the case in recent years.

In the professional literature from this area, there are different definitions of creative accounting such as:

- creative accounting involves the shaping of financial statements using the right choices and other actions permitted by the accounting regulative (Amat, Gowthorpe, 2004).
- creative accounting includes all the accounting practices that intentionally deviate from the standards in order to present desired and not real picture of the yield and financial strength of the company (Škarić-Jovanović, 2007).
- creative accounting includes a gain control and manipulation in connection with the classification of either the Balance Sheet or in the Income Statement (Škarić-Jovanović, 2011).
- The American Institute of Certified Public Accountants (AICPA) defines false financial reporting as intentional inaccuracy or omission of amounts or disclosures in

financial statements in order to deceive the users of financial report. This can include: manipulation, falsification or modification of the accounting records and accompanying documents, which are used in financial statements preparation; inaccurate (false) representations or deliberate omission of significant events or transactions from financial report and intentional misapplication of the accounting standards and rules (Stefanović, 2000).

- Creative accounting is the biggest scam after the Trojan horse (Dmitrović-Šaponja, 2007).
- Creative accounting is the process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the financial reports (Amat, Dowds, 1999).

According to most authors, the most complete definition of creative accounting is one which says that: “creative accounting includes any and all actions, including the aggressive choice and application of accounting standards, false financial reporting and all other steps taken to manipulate the data in the financial statements” (Mulford, Comiskey, 2002).

From the above definitions it is evident that creative financial reporting seriously derogates the usability of the financial statements, whether in terms of direct use of information which it contains, or in term of information basis for a serious analysis of the performance of a company.

The financial statements preparation respecting IAS is not a guarantee that they will accurately reflect the financial position and performance of the company, because it is possible to make steps of creative accounting even in the boundaries of IAS. The image of the company can be blurred further if steps of creative accounting are taken out of boundaries of IAS. Accordingly, it can be concluded that in terms of financial statements, measures of creative accounting undesirable because that financial reports don’t provide a clear picture of the company, and therefore don’t allow users making correct business decisions.

With measures of creative accounting, management of the company may affect the level of reported profit, the amount of reported net assets and the amount of reported cash from operating activities. In this paper, the term creative accounting will be used for marking of accounting practices that purposely deviate from the standards in order to present to the external users desired and not real picture about the cash flows from operating activities of the company.

3. Cash Flows Creative Reporting

Creative reporting of cash flows is relating to any step in order to create a different image than the actual cash flows, and in that way providing the wrong signal about the ability of the company to generate sustainable cash flows (Mulford, Comiskey, 2005). When we say sustainable cash flows, it is thought on cash flows from operating activities that is repeating from year to year. If there is some inflows of cash in only one year and in next year there is not we are not talking about sustainable cash flows. So, the main characteristics of sustainable cash flows are that they are cash flows from operating activities and are repeating from each operating year. According to that, in order to be successful, a company needs to achieve positive net cash flows from operating activities in the amount that is not less than in the amount in previous year.

All activities in the field of Cash flows creating accounting are focused on increasing net cash flows from operating activities. Achieving such result is possible in two ways:

1. By taking measures of creative accounting that are according IAS – within the limits prescribed by IAS and/or
2. By taking a measures of creative accounting that are beyond limits prescribed by IAS.

As it is already said, sustainable cash flows are directly depended on the cash flows from operating activities. IAS are clear in defining the cash flows from operating activities. Within these, there are considerable flexibility in their calculation and reporting. Some accountants are showing a willingness to take advantage or IAS flexibility in order to increase the presented amount of cash flows from operating activities. Despite the fact that these activities increase net cash flows from operating activities they do not increase sustainable cash flows since it is mainly a one-time increase.

In practice, there are many examples of cash flows reclassifying that artificially increase the net cash flows from operating activities by decreasing net cash flows from financing or investing activities. Below we listed some of them.

3.1. Operating vs. Investing activities

According to IAS 7 (paragraph 16), cash flows from investing activities includes cash outflows incurred to obtain the resources to participate in the creation of future earnings and cash flows and the cash invested in securities.

Many accountants and managers, with techniques and methods of creative accounting in accordance with IAS, are trying to increase the net cash flows from operating activities by reducing net cash flows from investing activities. There are three possibilities for that allowed by IAS regulations and may concern:

1. Investments held for trading.
2. Operating costs capitalization and
3. Acquisitions.

According to the IAS, investments in debt or equity securities can be classified like:

1. Investments held for trading.
2. Investments held to maturity.
3. Investments available for sale.

Investments held for trading are in the function of exploitation of short-term price fluctuations of these securities and on this basis profit generating. Holding periods are very short, sometimes shorter than one day.

Debt securities held to maturity are investments for which is the company's intention to hold them to maturity in order to cash it on the day of maturity with interest accrued.

Investments that don't belong to previous two groups are classified as investments available for sale. Depending on the time that elapses from the time of their acquisition to the date of sale investments available for sale can be classified as long-term or short-term investment.

The way of investment classification is in connection with classification of cash flows appeared from their buying or selling.

When investments are classified in the group of those held to maturity or available for sale, the cash outflows/inflows for their purchase/sale are classified as cash flows from investing activities. Unlike them, the cash flows of investments which are classified in the group of those held for trading belong to the group of cash flows from operating activities.

There are not strict rules for investment classification. That flexibility gives to the accountant's opportunity, if necessary, to rearrange cash flows by activity. If we invest in buying short-term securities, the cash outflows for that transaction belong to a group of investing activities. However, when we bought them, we can move them to a group of investments held for trading. With that action, after selling such securities, cash inflows from selling it belongs to a group of operating activities. With such transaction, we decreased net cash flow from investing activities (at the moment of their buying) and increased net cash flows from operating activities (at the moment of their selling).

The situation would be different if we have company whose main activities are trading with securities, like some financial institution (bank, insurance company…). Only in that case it is naturally to classify such activities as operating, but if it is not the case we shouldn't do such classification, primarily, because it is not sustainable cash flow and will appear only once (when the transaction of selling is done).

IAS provides a choice on certain operating costs in terms of whether it will be capitalized or will be reported as expenses at the moment of their occurrence. When they are considered as expenses, they reduce net income and net cash flows from operating activities. However, by capitalization, they are presented as outflows within investment activities and do not affect the cash flows from operating activities.

Costs of period are, in some cases in order to show better result (profit), capitalized, included into the value of an item of fixed assets and don't represent an expense of the period. They will be shown as expense at the moment when that item of fixed assets is amortized, so it will be written of gradually in a series of future periods. The most commonly used cases are:

- Capitalization of expenses for advertising campaign according to the IAS 38 – Intangible assets - advertising costs are very high, especially for new products marketing and they are particularly high in the early stage of product launch. In this stage the income from that product is on a very low level, so the companies, in order to show a better result, push expenses from the current period into future periods by capitalization of these costs.
- Capitalization of research and development costs – these costs also make expense of the period, but in some cases they are capitalized (according to the IAS 38).
- Capitalization of costs incurred directly before the factory opening – costs of establishing are not capitalized, but in many cases this practice is recorded (IAS 16 – Property, plant and equipment).
- Capitalization of maintenance and repair costs – these are typical operating costs required for the normal functioning of the assets to which they relate, but in certain cases, in order to improve the business result and performance, they are being attributed to an item of fixed assets (according to the IAS 16).
- Capitalization of interest on loans taken for purchase of fixed assets - in accordance with IAS 23 – Borrowing costs, the capitalization of interest on loans that are taken for purchase of fixed assets is permissible procedure. Capitalization of interest leads to higher net cash flows from operating activities because the amounts of capitalized interest increases the cost value of the fixed asset, and lower net cash flows from investing activities. This procedure should be disclosed in the Notes to the Financial Statements.

The company WorldCom is an example of creative accounting that did capitalization of expenses that are typical expenses of the period. In this way the company has falsely increased net income and net cash flows from operating activities of approximately 3,8 billion US dollars. The company HealthSouth capitalized costs of sponsoring hockey team in Pennsylvania and the cost of advertising in newspapers.

Contrary, in period from 1997 to 1999 the Microsoft Company didn't capitalize the costs of development, although it is allowed. Microsoft treated that costs as the costs of the period which resulted in lower financial result than it was in reality. The motivation for such an action was attention to reduce monopoly.

Typical examples of the expenses that are capitalized are costs of software development. In accordance with IAS 38 – Intangible Assets, capitalization of additional costs is required when it reaches technological feasibility. However, it is questionable if and when is that level reached, and therefore there is a great freedom in determining that moment and the moment when the additional costs would be capitalized.

By its recognition at the time of occurrence, the costs of software development affect net income and net cash flows from operating activities. But, when they are capitalized they are cash outflows from investing activities and do not affect the cash flows from operating activities, which positively affects the net cash flows from operating activities.

The level when technological feasibility is reached is the level where the additional amortization of capitalized costs of software development from the previous period is approximately equal to the new capitalized costs in the current period. It means that the effects from that capitalization are about zero. However, analysts do not need to worry so much about the effects on earning of companies, but concerns should be directed to the policy of capitalization. Even when the effects on earnings of capitalization are zero, cash outflows are still treating as outflows from investing activities that is continuously increasing net cash flow from operating activities.

The effects of capitalization on the cash flows from operating activities are particularly noticeable when the company is changing its policy of capitalization.

Acquisition of the company is a business action in which one company – Buyer Company takes other company – Target Company and after that the target company is doing business within the main company. When a Buyer Company did such transaction, from that moment, the results of the Target Company are included in financial reports of the Buyer Company. Thus, the acquisition could be in the service of increasing profit and net cash flows from operating activities. Increasing of net cash flows from operating activities from acquisition is not sustainable, it is only one-time transaction.

Working capital increased through accounts such as receivable, inventories, accruals… reduce net cash flow from operating activities. When the specified working capital decreases the result is increasing of net cash flow from operating activities.

According to IAS 7 (paragraph 39), Cash flows from working capital got from acquisition, are presenting separately and classifying as investing activities. However, the liquidation of working capital, and in the case where it comes from acquisition, is presenting like additional cash flows from operating activities.

3.1. Operating vs. Financing activities

Cash flows from financing activities is consisted of cash inflows and outflows from the issue of shares and other securities, debt repayment, purchase of own shares, payment of dividends… As the cash flows for investing activities, cash flows from financial activities are not sustainable cash flows as it is the case with cash flows from operating activities.

IAS flexibility can be used to increase the inflows of operating activities by decreasing the inflows of financing activities. Within the IAS, there are three ways for such activities:

1. Current account overdrafts classifying as operating inflows and not as financial.
2. Receivables selling.
3. Supplier's credit.

Within IAS 7 (paragraph 8) states: Bank borrowings are generally considered to be financing activities. However, in some countries it is allowed that bank overdrafts repayable on demand are integral part of company's cash management. In these cases, allowed bank overdrafts are included as a component of cash and cash equivalents. The characteristics of such arrangements are that the bank balance often fluctuates from positive to negative (in the amount of allowed overdraft). Having this flexibility, many companies, by using allowed overdrafts, increase their cash inflows from operating activities.

Sale of receivables is another option available to the accountants to increase net cash flows from operating activities by decreasing net cash flows from financing activities. Reducing the amount of receivables and increased cash inflow will increase net cash flow from operating activities. The company has legitimate right to use Factoring in other to collect its receivables, however when receivables are putted as collateral for a loan, all proceeds on the basis of them should be threaded as financing activities.

According to some authors, sales of receivables and operating cash flows are two entirely different things. Sales of receivables are just cheap sources of financing, and as such should belong to cash flows from financing activities. (Sender, 2002).

Supplier's credit is a form of financing that is, in accordance to IAS, presenting as cash flows from operating activities. Increasing inflows from operating activities, on the one hand, results in an increase in liabilities to a supplier on the other. Extension of time for payment, liabilities to a supplier can be an effective means to increase working capital. However, additional amounts of cash, achieved in this way, are not sustainable. It will be repeated next year only if there is a further extension of time for payment (if it is 45 days in the current year, next year it should be more than 45 days).

CONCLUSION

It is evident that the creativity of accountants in presenting the results of the company occurred even before the occurrence of the creative accounting as a term. But the creativity of accountants today is much greater than in the past. As a result of that creativity, we have increasingly undermining the credibility of financial statements and the accounting profession.

The importance of information provided by Statement of cash flows to its users only increased the need for creativity in this field of reporting. The importance of cash flows from operating activities compared to the cash flows from financing and investing activities led accountants to distort the true picture of the cash flows and to make steps in increasing net cash flows from operating activities, by decreasing net cash flows from investing and financing activities. Such cash flows are not sustainable and it is obvious that accountants with those actions want to present some distorted picture of cash flows. Most of these measures (often all) gives only one-time increase in net cash flows from operating activities, and do not improve sustainability.

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KREATIVNO RAČUNOVODSTVO I FINANSIJSKO IZVEŠTAVANJE O TOKOVIMA GOTOVINE

Sistem finansijskog izveštavanja je razvijen tako da obezbedi pouzdane informacije za njegove korisnike. Medjutim, bez obzira na to koliko se teži da sistem finansijskog izveštavanja obezbedi kvalitetne informacije, uvek postoje odredjene okolnosti tj. slabe tačke koje mogu dovesti do neispravnih finansijskih izveštaja. Na pojavu nepravilnosti utiču sledeći faktori: složena ekonomska stvarnost, računovodstvene politike i procene, lanac učesnika u procesu sastavljanja i prezentacije finansijskih izveštaja i specifični procesi u okviru priznavanja i merenja pozicija u finansijkim izveštajima.

Kreativnim računovodstvom se vrši transformacija finansijskih izveštaja od onoga što je stvarno u ono što subjekt želi prikazati koristeći postojeća pravila i/ili ignorišući neka od njih. Kreativnim računovodstvom može se uticati na visinu iskazane dobiti, visinu iskazane neto imvine i visinu iskazane neto gotovine iz poslovnih aktivnosti. U ovom radu termin kreativno računovdstvo će biti korišćen, za označavanje svih računovodstvenih praksi koje namerno odstupaju od standarda da bi eksternim korisnicima bila prezentirana željena a ne stvarna slika o novčanim tokovima iz poslovne aktivnosti preduzeća.

Ključne reči: *finansijsko izveštavanje, kreativno računovdstvo, novčani tokovi, poslovna aktivnost*.